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Supreme Court of the United States

OCTOBER TERM, 1963

No. 656

AMERICAN CAN COMPANY,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit

PETITIONER'S REPLY BRIEF

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The Accrual Issue

In opposing the petition for a writ of certiorari on the accrual issue, Respondent asserts that the question presented is whether the taxpayer is entitled to change its method of accounting without first obtaining the Commissioner's agreement to such a change. But that is not the question here. Rather, the question is whether the Commissioner may require an accrual basis taxpayer to deduct vacation pay and certain property tax expenses in a year other than the year in which such expenses accrued, where the taxpayer had in prior years deducted similar expenses in the wrong period. The taxpayer agrees, of course, that the

Commissioner's prior consent would be required if the taxpayer were seeking to change its method of accounting. The taxpayer, however, seeks not to change its method of accounting but only to apply its method of accounting to certain items of expense which had been erroneously treated in prior years. See *United States v. American Can Co.*, 280 U.S. 412 (1930).

As stated in the Petition (pp. 17-18), the rationale of the requirement that a taxpayer must obtain the Commissioner's permission before making a change in its method of accounting is that a change in method of accounting will in general result in the permanent omission of items of income or the allowance of two deductions for the same item of expense. To protect the revenue from such "distortion of income," the Commissioner may withhold his consent until the taxpayer agrees to adjustments that will prevent duplication of deduction items or omission of income items as a result of the change.* *Brookshire v. Commissioner*, 273 F.2d 638 (4th Cir.), *cert. denied*, 363 U.S. 827 (1960). See also Treas. Reg. 118, § 39.41-2(c).

Unlike the case of a change in method of accounting, however, no "distortion of income" can result from

* For example, if a cash basis taxpayer were to change its method of accounting to the accrual basis, income earned in the year before the change and received in the year of the change would, without adjustments, not properly be includible in taxable income in either of such years. Similarly, if an accrual basis taxpayer were to change its method of accounting to the cash basis, an expense which accrued in the year before the change and was paid in the year of the change would, without adjustments, be properly deductible in both years. Consequently, in order to prevent such omissions or duplications, the Commissioner is given the power to demand appropriate adjustments as a condition of allowing a taxpayer to change its method of accounting. See Treas. Reg. 118, § 39.41-2(c); see also Int. Rev. Code of 1954, § 481.

the correction of an error because in such case there is no possibility that an item of income may properly be omitted from the computation of taxable income or that an item of expense may properly be the source of more than one deduction. If, under a taxpayer's method of accounting, an item is properly taken into account in one year, it is by hypothesis improper to take the same item into account in any other year. Correction of any other year in which the item may have been improperly included or deducted is open, apart from the statute of limitations, either to the taxpayer or to the Commissioner, as the case may be. Therefore, the reason for the rule requiring the consent of the Commissioner to a change in method of accounting does not exist in the case of the correction of an error.

Respondent implies (Brief, pp. 9-10) that the purpose of the regulation requiring the Commissioner's prior consent is to prevent not only the omission of income and the duplication of deductions but also the "bunching of deduction items." As shown in the Petition (pp. 17-18), however, it is clear under Treasury Regulation 118, § 39.41-2(c) that the Commissioner is concerned only with preventing the omission of income and the duplication of deductions.* Moreover, although Respondent argues that in the present case the correction sought by the taxpayer "would branch two years' expenses in 1952," it is apparent that the bunching

* See also section 481 of the Internal Revenue Code of 1954 which restricts the adjustments the Commissioner can make in the case of a change in method of accounting to those designed to prevent amounts "from being duplicated or omitted." Moreover, it should be noted that adjustments required by the Commissioner as a condition of making a change in accounting method cause, rather than prevent, the bunching of income or deduction items.

referred to by Respondent results only from the taxpayer's being entitled to an adjustment which has the effect of allowing the taxpayer to deduct in 1952, a year otherwise barred by the statute of limitations, the expenses that accrued in that year as well as those that were paid in that year. Such adjustment is specifically required by sections 1311-15 of the Internal Revenue Code of 1954 which provide a method of adjustment where the correction of an error would otherwise be prevented by the statute of limitations.*

The adjustment under sections 1311-15 does not allow the taxpayer more than one deduction for a single item of expense. Indeed, if the adjustment were not

* Sections 1311-15 provide, among other things, that if (i) a decision of the Tax Court disallows a deduction which should have been allowed to, but was not allowed to, the taxpayer for another taxable year, (ii) the correction of the error is prevented by the statute of limitations, and (iii) refund of the overpayment attributable to the deduction which should have been allowed was not barred by the statute of limitations at the time the taxpayer first maintained before the Commissioner that he was entitled to such deduction (e. g., by claiming it in his tax return for a later year), then the "effect of the error" shall be corrected by an adjustment. The adjustment is defined as the decrease in tax which results solely from the correct treatment of the deduction, i. e., the amount of the adjustment shall not be diminished by any set-off based upon any item other than the one which was the subject of the adjustment. These sections reflect the intent of Congress to correct an error by making an adjustment in only one year rather than in each of the prior years.

The applicability of sections 1311-15 to the facts in the present case was acknowledged by the Commissioner in Revenue Ruling 57-13, 1957-1 Cum. Bull. 552, and in Revenue Ruling 58-21, 1958-1 Cum. Bull. 318, which states:

"The allowance of the deduction in the year 1952 for vacation pay disallowed for 1953 results in a pyramiding of vacation pay deductions in 1952 one on the cash method, attributable to 1951, and one on the accrual method. Despite this result, section 1314(c) of the Code provides that the amount to be refunded or credited in the same manner as an overpayment shall not be diminished by any credit or set-off based upon any item other than the one which was the subject of the adjustment."

made, the taxpayer would be permanently denied a deduction for the vacation pay and property tax expenses that accrued in 1952.* The provisions of sections 1311-15 were included in the Code specifically to deal with situations, such as the present case, where no omission or duplication of items is involved, but where the statute of limitations would otherwise preclude an adjustment resulting from the correction of an error. For that reason, Congress made the operation of these sections mandatory and not subject to the Commissioner's consent.

The adjustments provided in sections 1311-15 are available to both the Commissioner and the taxpayer. Thus, in *United States v. Consolidated Edison Co.*, 366 U.S. 380 (1961), holding that the taxpayer was entitled to correct its erroneous treatment of property taxes, this Court noted that the Commissioner would be entitled to an adjustment under sections 1311-15 with respect to the deductions erroneously taken in prior years otherwise closed by the statute of limitations.

Although Respondent asserts (Brief, p. 10) that there was "no bunching" in *Consolidated Edison*, the fact is that the decision of this Court resulted in reducing the income of a single year by approximately

* The Government states (Brief, p. 10, fn. 4) that the so-called "distortion" resulting in the present case from the adjustment permitted by sections 1311-15 "is particularly significant because 1952 was an excess-profits tax year". The implication is that the taxpayer is seeking to obtain an advantage from the expense deductions by using them to offset income taxable at excess profits tax rates rather than at ordinary corporate rates. However, as counsel for the Government conceded on oral argument in the court below the taxpayer was not subject to excess profits tax in 1952 and so could not have had the motive attributed to it.

$13,000,000, which reduction would otherwise have been spread over a five-year period. (See Petition, p. 19, fn.) Respondent also attempts (Brief, p. 10) to avoid the controlling effect of the decision in the *Consolidated Edison* case on the ground that it did not involve "the question of a taxpayer's right to change a consistent method of accounting without the Commissioner's consent." Neither, of course, does this case. Moreover, in the *Consolidated Edison* case, as in the present case, the taxpayer had for many years deducted in its tax returns the item of expense in question in the year of payment rather than in the year of accrual. Notwithstanding such long-continued "treatment of a material item," this Court applied the rule that "neither the Government nor an accrual basis taxpayer may cause an item to be deducted in a year other than the one in which it accrued." (366 U.S. 380, at p. 385)

In sum, the decision of the Court of Appeals in the present case cannot be reconciled with this Court's decision in *Consolidated Edison* or the long line of Supreme Court decisions cited therein. Accordingly, Petitioner urges that a writ of certiorari be granted with respect to this issue.

The Capital Gain Issue

The brief for Respondent does not deal with either of the questions presented under section 117(j) of the Internal Revenue Code of 1939, viz: (1) whether the statutory phrase "held by the taxpayer primarily for sale" applies to property which is held principally, chiefly or predominantly for a purpose other than sale,

and (2) whether the statutory phrase "in the ordinary course of [a taxpayer's] trade or business" applies to the sale of property held for many years solely for use in a taxpayer's trade or business and ultimately sold only because of the mandatory provisions of an anti-trust decree, at prices fixed by the decree that had no relation to the value of the property.

It is respectfully submitted that, for the reasons stated in the Petition, these questions should be decided by this Court.

Conclusion

For the foregoing reasons, the petition for a writ of certiorari should be granted.

Respectfully submitted,

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January, 1964